

March 2, 2001

BY HAND

Mary L. Cottrell, Secretary
Department of Telecommunications and Energy
One South Station, 2nd Floor
Boston, MA 02110

Re: Fitchburg Gas and Electric Light Company, D.T.E. 99-118

Dear Ms. Cottrell:

Enclosed please find an original and eight (8) copies of the Prefiled Testimony of Mark H. Collin in the above docket. Pursuant to the groundrules in this proceeding, a copy of this Prefiled Testimony has been e-mailed to the Department at "dte.efiling@state.ma.us."

Thank you for your assistance with this matter.

Very truly yours,

Scott J. Mueller

cc: Robert Howley, Esq., Hearing Officer
Lincoln Daly, Rates
Paul Osborne, Rates
Alexander J. Cochis, Esq., Assistant Attorney General (4 copies)
George B. Dean, Esq., Assistant Attorney General
Service List

CERTIFICATION

I, Scott J. Mueller, hereby certify that I have, this 2nd day of March, 2001, caused a copy of the attached Prefiled Testimony on each individual on the service list on file in Docket 99-118 with the Secretary of the Department of Telecommunications and Energy.

Dated at Boston, Massachusetts, this 2nd day of March, 2001.

Scott J. Mueller

FITCHBURG GAS & ELECTRIC LIGHT COMPANY

D.T.E. 99-118

DIRECT TESTIMONY OF MARK H. COLLIN

March 2, 2001

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1 I. INTRODUCTION

2

3

4 Q. Please state your name and business address.

5 A. Mark H. Collin, 6 Liberty Lane West, Hampton, New Hampshire

6

7 Q. What is your position and what are your responsibilities with FG&E?

8 A. I am the Treasurer of Fitchburg Gas and Electric Light Company ("FG&E"). I
9 have held that position since 1992. I am also the Treasurer and Secretary of Unitil
10 Corporation, which is the parent company of FG&E. I have held that position
11 since 1998. My areas of responsibility are primarily in financial and corporate
12 planning, and treasury-related and regulatory services.

13

14 Q. Please describe your business and educational background.

15 A. I joined Unitil Service Corp. as the Manager of Rates in September 1988. I was
16 promoted to Manager of Regulatory Services in 1989 and Assistant Vice
17 President of Regulatory Services in 1991. I transferred to the position of
18 Assistant Vice President of Finance in September of 1992. I was also appointed
19 the Unitil System subsidiary Treasurer in 1992 and Vice President of Finance and
20 Administration in 1995. I assumed my current responsibilities as Treasurer of
21 Unitil Corporation in 1998.

22

23 Prior to joining Unitil Service Corp., I was employed as an economist and utility
24 analyst in the Economics Department of the New Hampshire Public Utilities
25 Commission. As a member of the New Hampshire Commission staff, I was

1 primarily responsible for providing the Commission with economic and technical
2 analyses on a broad range of regulatory, economic and financial matters in the gas
3 and electric utility industry.

4
5 I earned a Bachelor of Arts in Economics and a minor in Management from the
6 State University of New York at Cortland in 1981 and a Master of Arts in
7 Economics from the University of New Hampshire Whittemore School of
8 Business and Economics in 1984.

9
10 Q. Have you previously testified before the Department of Telecommunications and
11 Energy ("the Department") or other regulatory agencies?

12 A. Yes. I have testified on behalf of the Unitil Companies before the Department as
13 well as before the New Hampshire Public Utilities Commission.

14 I have also testified on behalf of the New Hampshire Public Utilities Commission
15 in the areas of rate of return regulation and cost of capital.

16
17 Q. What is the purpose of your testimony in this proceeding?

18 A. The purpose of my testimony is to respond to the claim of David J. Effron, the
19 Attorney General's witness, that FG&E's electric distribution operations
20 generated excess revenue of \$3,116,000 in calendar year 1999.

21

22

1 II. THE ATTORNEY GENERAL'S SIMPLIFIED APPROACH
2

3 Q. Please describe your understanding of the nature of the analysis performed by Mr.
4 Effron.

5 A. Mr. Effron has calculated a simple return on average common equity for FG&E's
6 regulated electric utility operations for the calendar years 1997, 1998 and 1999.
7 He has used this methodology to derive an indicated level of return and resulting
8 excess revenue level, which he attributes entirely to FG&E's electric distribution
9 operations. To the extent his method does attempt to calculate the expenses of
10 FG&E's electric operations, he relies on per-books information.
11

12 Q. Can the appropriate revenue requirement for purposes of establishing base rates
13 be approximated through the simplified analysis proffered by Mr. Effron?

14 A. No. I am not aware of any instance in which base rates have been adjusted by
15 relying upon a methodology such as that proposed by Mr. Effron.
16

17 Q. Why not?

18 A. As I explain in more detail below, my understanding of the methodology
19 traditionally employed by the Department is that a utility's revenue requirement is
20 determined through a detailed cost of service study. The cost of service for
21 distribution service is isolated, and then normalizing adjustments are applied to
22 reflect known and measurable changes. The utility's revenue requirement is

1 uniformly supported by expert or utility testimony that demonstrates the expenses
2 and rate base items included are consistent with Department precedent. In
3 general, test-year expenses may be included or normalized if they are expected to
4 recur annually or periodically. If any expenses are extraordinary but non-
5 recurring, recovery may be amortized over an appropriate period of years.

6
7 As I discuss further below, all utilities seeking a rate increase must show *at a*
8 *minimum* that proposed test year expenses and adjustments conform to a number
9 of standards and criteria employed by the Department in evaluating the different
10 categories of expenses and rate base. Rate reductions should be subject to the
11 same level of scrutiny. However, it is my opinion that the Attorney General's
12 chosen method does not meet this exacting standard, fails to demonstrate that
13 FG&E's current rates are unjust or unreasonable, and does not demonstrate any
14 exigency for which rate relief under any other set of circumstances is warranted.

15
16 III. BACKGROUND OF PROCEEDING
17

18 Q. Please describe your understanding of the scope of this proceeding.

19 A. The Department noticed this proceeding as an investigation of FG&E's electric
20 rates under Chapter 164, § 93 in response to the Attorney General's complaint
21 filed on December 31, 1999. The complaint made two allegations: first, that
22 FG&E's rate of return for its electric division was excessive, and second, that

1 FG&E's depreciation accruals for the electric division were insufficient. It is my
2 understanding that there is little precedent for a § 93 action. In the two cases I am
3 aware of, the § 93 complaint led to the filing of a base rate case by the utility
4 under M.G.L. c. 164, § 94, and in the other, the Department dismissed the
5 complaint.

6
7 Q. The Department ordered a fast-track review in this proceeding. What does that
8 tell you?

9 A. While the scope in this proceeding is still undefined, the Department's expedited
10 procedural schedule implies an intent to focus on the merits of the specific
11 allegations set forth in the Attorney General's complaint. Even though FG&E
12 offered to file a cost of service study and full base rate case, the schedule set by
13 the Department does not allow sufficient time for such a filing. The procedural
14 schedule placed the burden on the Attorney General to file initial testimony within
15 six weeks, followed by FG&E's testimony three weeks later. This schedule may
16 provide adequate time to determine whether there is any merit to the Attorney
17 General's allegations; it does not provide the time or procedures for *the*
18 *preparation and review* of a full cost of service pursuant to the traditional revenue
19 requirement methodology relied upon by the Department when making changes in
20 base rates.

21

IV. THE REVENUE REQUIREMENTS METHODOLOGY USED TO
DETERMINE RATES

Q. Please describe the traditional revenue requirement method used to determine just and reasonable base rates for gas and electric companies in the Commonwealth.

A. The revenue requirement standard for establishing base rates includes two components - the operating costs for the utility and a fair return on rate base. This methodology can be expressed as a formula:

$$R = O + (C-D)r.$$

where

R is the total revenue requirement

O is the operating costs of the utility, including taxes

C is the gross cost of tangible and intangible property

D is the accrued depreciation and other property-related deductions

and

r is the allowed rate of return.

Under this formula, C minus D is the utility's rate base.

In order to complete this calculation, the party proposing the rate change (usually the utility) must engage in three major steps. It must (1) determine the cost of operation; (2) determine the rate base; and (3) determine the rate of return. Each step requires a significant effort to collect raw data, to allocate costs and revenues, to verify and refine the data, to evaluate the data to determine what costs and revenues are appropriate for inclusion under Department precedent, to prepare the cost of service and finally, to develop testimony and supporting materials for the ultimate review and scrutiny of the Department and any intervenors. Preparing a rate case requires many months of data collection and analysis. It typically

1 involves numerous outside consultants and experts to develop and present the
2 request for an adjustment to base rates.

3
4 Q. With regard to the major components you identified for calculating a revenue
5 requirement, please describe what is involved in the development, calculation and
6 presentation of a company's operating expenses for a base rate case.

7 A. Recovery of operating expenses makes up the largest component of a utility base
8 rate revenue requirement. Operating expenses include every category of cost,
9 including but not limited to wages and salaries, maintenance, outside vendors,
10 insurance, pension and employee benefits, as well as depreciation and taxes.

11
12 Q. How are operating expenses determined by a utility for the purposes of
13 establishing a just and reasonable rate?

14 A. The utility must first determine the test year expenses, and then evaluate the need
15 for any *pro forma* adjustments to reflect known and measurable changes in these
16 expenses for the future period the rates will be in effect. This is a resource-
17 intensive effort that involves collecting data, reviewing and analyzing extensive
18 records and information, allocating costs between operations (such as electric and
19 gas), unbundling various components, calculating annual amounts, and evaluating
20 and finalizing *pro forma* adjustments.

21
22 Q. Are there any other analyses undertaken?

1 A. Yes. In addition to determining and making pro forma adjustments to the
2 operating expenses, the utility typically conducts a depreciation study to
3 determine the appropriate annual accrual rates and annual depreciation expense.
4 The depreciation study involves a detailed statistical analysis of all relevant plant
5 records, particularly with regard to additions and retirements. The depreciation
6 study calculates the indicated level of depreciation reserve for each account and,
7 when there is a discrepancy from actual reserves, the utility may recommend a
8 change to the depreciation rate along with a higher or lower level of depreciation
9 expense.

10
11 I want to point out that there are different formulas and standards for determining
12 the level for virtually all allowable expenses or adjustments in the various
13 categories of costs, such as rate case expense, bad debt expense and inflation
14 allowance. All of these analyses must be completed in order to establish the
15 appropriate level of operations expenses to be included in the utility's revenue
16 requirements.

17
18 Q. Please describe what other steps are involved in determining a utility's revenue
19 requirement.

20 A. Under Department precedent, a utility's rate base is determined predominantly
21 using balances as of year-end, or in other words, at the end of the test year. For a
22 calendar year test year, preparation of the rate case typically follows the closing
23 and auditing of the utility's books at the end of the year, which is itself a five- to

1 six-week process. The utility evaluates the raw data to determine if it should be
2 included in rate base under Department precedent. Under this standard, any rate
3 base item must be used and useful and its cost prudently incurred.
4

5 Q. Would that be sufficient to determine the rate base accurately for a combined
6 utility such as FG&E?

7 A. Not at all. In addition to collecting and verifying the raw data, a combination
8 utility such as FG&E must allocate components of its rate base between its
9 electric and gas operations. Moreover, as a result of the restructuring of the
10 electric operations, FG&E must also unbundle its distribution property not only
11 from common property but also from property associated with the electric
12 transmission and generation function. As a result of electric restructuring, FG&E
13 has begun to account for its costs and revenues on an unbundled basis. Quite
14 significantly, with regard to Mr. Effron's analysis of the level of FG&E's rate
15 base, any utility seeking a rate change must be prepared to provide clear, cohesive
16 and reviewable evidence on each base rate component.
17

18 Q. Did Mr. Effron present this kind of substantial evidence?

19 A. No, he did not.
20

21 Q. When the burden is on a utility to demonstrate the reasonableness of its change in
22 rates, does the calculation and presentation of rate base require analysis or
23 adjustments to the test year data?

24 A. Yes. In addition to the use of test year-end data, the calculation of the rate base
25 also includes cash working capital allowance and materials and supplies inventory
26 components. Utilities require cash-working capital to pay for on-going operating
27 and maintenance expenses, which they fund either through internally-generated
28 sources or by external financing. The Department provides for the reimbursement
29 of the costs associated with the utility's use of these funds by including a cash

1 working capital component in base rates. The cash-working capital component is
2 determined by a lead-lag study, by use of a 45 day convention, or by employing
3 an alternative measure for estimating a utility's working capital requirement.
4 Similarly, a utility is reimbursed for use of these funds to maintain an inventory of
5 materials and supplies for utility operations.
6

7 Q. Are post test year adjustments to rate base permitted?

8 A. In some circumstances, but a utility seeking a rate change must always consider
9 whether there are any post-test year adjustments to rate base. For example, when
10 utility plant investment is added after the end of the test year, but is in service and
11 providing benefits to customers, it may be added if it is expected to have a
12 significant impact upon rate base.
13

14 Q. Did Mr. Effron consider these complexities in his analysis?

15 A. No, he did not. When a utility files to change its rates, it must be prepared to
16 support its rate base within the revenue requirements methodology. It must
17 perform a detailed and in-depth review of the rate base components.
18

19 Q. The third major component you noted for developing a revenue requirement is
20 determining the appropriate rate of return. What is typically involved in this
21 process?

22 A. Generally, the party proposing the rate change (again, in most cases, the utility)
23 presents expert testimony on the appropriate return on common equity, given the
24 particular circumstances of the regulated company. Under the Department's
25 standard, return on common equity should be set at a level that will (1) preserve
26 the regulated utility's financial integrity, (2) allow the utility to attract capital on

1 reasonable terms, and (3) be comparable to earnings on investments of similar
2 risk. As a general matter, the Department relies on expert opinion to provide a
3 detailed and reasoned analysis relative to the appropriate cost of common equity.
4 This analysis typically involves identification of a barometer group of comparable
5 utilities, a discounted cash flow (DCF) analysis, and often a risk premium
6 evaluation.

7
8 Q. Did Mr. Effron employ such an analysis?

9 A. As I discuss further below, he did not.
10

11 Q. Have there been any specific contributions to the earnings of FG&E's electric
12 operations in recent years?

13 A. Yes, there have. Two occurrences contributed significantly to earnings level.
14

15 Q. What are they?

16 A. The first was the addition of a large Special Contract customer in 1996. FG&E
17 executed a Special Contract with the Massachusetts Recycling Associates Limited
18 Partnership ("MRA" or "MRALP") on September 8, 1995. Upon the completion
19 of necessary conditions, the agreement became effective on February 6, 1996.
20 Unfortunately, MRA declared bankruptcy in August of 1998. Fitchburg
21 Operating Company L.L.C. ("FOLLC") emerged from the bankruptcy as the new
22 owner.

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Q. Was FG&E able to replace the lost load with FOLLC?

A. Yes. FG&E entered into a service agreement with FOLLC under its Energy Bank Service tariffs (the "EBS Agreement") on January 20, 1998. The first billing for service under the EBS Agreement was January 1999. On February 23, 1999, FG&E was notified that FOLLC had been renamed Princeton Paper Company, L.L.C.. However, Princeton Paper Company declared bankruptcy on June 7, 1999.

Q. What was the other occurrence?

A. The other was the 1992 merger with Unitil that resulted in operational and administrative efficiencies that have had a favorable cumulative impact on earnings.

Q. Did Mr. Effron discuss either of these events in his testimony in any manner?

A. No, he did not.

Q. You have discussed cost of service analyses, rate base and rate of return. Are there any other analyses that take place in determining rates for a regulated utility?

A. Yes. The Department often investigates the rate structure that will be used to collect the utility's revenue requirement. This aspect is of great import to customers.

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Q. How is rate structure determined?

A. Rate structures are captured in a utility's rate design. Utility rate design proposals are created by establishing the level and pattern of prices that various classes of customers will be charged for use of a particular utility service. This process involves two cost allocation studies (accounting and marginal) to assign a portion of the utility's total costs to each rate class. The utility then designs rates to determine a set of prices for each class that will produce revenues equal to the costs allocated to that class. In order to conduct a cost allocation study, the utility must: (1) functionalize costs; (2) classify expenses in each functional category according to the factors underlying their causation; (3) identify an appropriate allocator for costs in each classification within each function; (4) allocate all of the costs to each rate class based upon the cost groupings and allocators and sum these allocations to determine the total cost of serving each rate class; and (5) compare allocated costs and test year revenues to determine how to allocate the rate increase or decrease consistent with the Department's rate design goals.

Q. Did Mr. Effron examine the manner in which rates are collected from FG&E's customers or suggest a rate design by which his proposed decrease should be collected from FG&E's customers?

A. No, he did not.

1 Q. Do all utilities still file traditional rate changes under rate of return regulation?

2 A. I don't believe so. In recent years the Department moved purposefully towards
3 the establishment of performance based rates ("PBR"). A utility seeking a base
4 rate adjustment is now required to file a PBR plan along with such a request, or if
5 it fails to do so, it must describe in detail the efforts undertaken to achieve more
6 efficient operations, better cost control and lower rates to consumers. Such a
7 utility must also explain why it did not submit an incentive rate proposal.

8

9 Q. What are the broad components of a PBR?

10 A. At the minimum, a PBR is recognizable by the performance benchmarks
11 established that are intended to maintain service quality. In addition, a PBR
12 usually includes some type of broad-based incentive, typically either through
13 shared earnings or a price-cap mechanism. One of the purposes of PBR is to
14 move away from a measuring a utilities performance based on traditional rate of
15 return regulation and rather focus regulation on the prices a utility charges and the
16 quality of services it delivers to its customers.

17

18 Q. Did Mr. Effron propose an incentive rate proposal as part of his proposed change
19 to FG&E's base rates?

20 A. No, he did not.

21

1 V. THE EFFRON REVENUE REQUIREMENT AND RATE OF
2 RETURN CALCULATION
3

4 Q. Now that you have explained the appropriate way to determine a just and
5 reasonable rate under Department standards, is it your expectation that
6 determining FG&E's current revenue requirement would be such a straight-
7 forward calculation that could be approximated based upon the per-books analysis
8 employed by Mr. Effron?

9 A. No, not at all. In addition to the concerns stated above and his failure to conduct
10 any of the diligence required of a utility seeking a change in rates, due to
11 unbundling of electric distribution operations from generation functions,
12 calculation of the revenue requirement associated with only FG&E's electric
13 distribution operations will have to be undertaken for the first time in the context
14 of a base rate case. I fully expect that this process will require a lengthy and
15 resource intensive effort, and I do not believe that the results can be predicted
16 based upon the type of superficial analysis offered by Mr. Effron.
17

18 Q. Mr. Effron proposes that the Department impose upon FG&E a rate of return of
19 10.58 percent. Has he provided substantial evidence to support this
20 recommendation?

21 A. The Attorney General has offered no expert testimony on the appropriate return
22 on equity for FG&E. Mr. Effron makes it clear in his submission that he is not
23 providing expert testimony on the cost of common equity.
24

1 Q. Are you aware of any instance where a Commission has changed a utility's
2 allowed return on equity without full consideration of its expense levels and rate
3 base?

4 A. No, I am not. Changing one component of the formula for calculating revenue
5 requirements, without review and consideration of changes to other components
6 of that formula would, in my view, violate the general prohibition against single-
7 issue rate cases.

8
9 Q. Do you agree with the use of Mr. Effron's type of return calculation to derive and
10 support a recommendation for a base rate change, either an increase or a
11 decrease?

12 A. Not within the context of cost of service-based ratemaking. The process to
13 change base rates has always been, and should be, based upon a detailed review of
14 all of a company's expenses, its rate base and the calculation of a reasonable
15 return for the most recent test year period, accounting for known and measurable
16 changes, in accordance with the established procedures described above.

17
18 Q. Of what use do you view the return on common equity proposal filed by Mr.
19 Effron in this proceeding?

20 A. Although I believe using Mr. Effron's methodology to justify a change in base
21 rates is flawed for the reasons previously stated , I believe that it may be able to
22 serve as a measurement tool to indicate a potential need for further earnings

1 analysis, after modifications have been made to reflect certain critical cost of
2 service ratemaking policies and principles of the Department.

3
4 Q. Before I ask you to describe your modifications, please tell the Department
5 whether those adjustments indicate that any further earnings analysis is warranted.

6 A. I believe no further earnings analysis is warranted.
7

8 VI. ADJUSTMENTS TO MR. EFFRON'S CLAIMED EXCESS REVENUE
9 CALCULATION
10

11
12 Q. Please describe the modifications to Mr. Effron's claimed excess revenue
13 calculation that you would propose.

14 A. First, I believe the calculation should be performed using a more current period.
15 The audited financial results of FG&E for calendar year 2000 have just become
16 available and have been supplied to the Attorney General. Second, FG&E's
17 return should be calculated using the common equity balance at the end of the
18 period, consistent with Department precedent. Third, certain normalizing
19 adjustments to FG&E's revenue and expenses in the test year can and must be
20 made to provide the balanced analysis that would ordinarily occur in a cost of
21 service rate setting proceeding.
22

23 Q. Have you prepared a schedule showing these modifications to the calculation
24 proposed by Mr. Effron in his testimony in this proceeding?

1 A. Yes, I have. Exhibit MHC-1 presents this modified calculation.

2
3 Q. Please describe Exhibit MHC-1.

4 A. I have used the same format as Mr. Effron, showing his calculation of an excess
5 revenue of \$3,116,000 for calendar year 1999. My first adjustment was to use the
6 data and information from the most recently available test year, including
7 common equity balance at the end of the year. Use of the most recent calendar
8 year 2000 information reduces the claimed excess under Mr. Effron's
9 methodology by \$1,243,000. I then proformed and made certain normalizing
10 adjustments to revenues and expenses. These adjustment, coupled with the use of
11 the most recent 2000 test year information, reduce the claimed excess under Mr.
12 Effron's methodology by \$2,117,000. Finally, I make two additional adjustments
13 in my calculation for depreciation expense and amortization of rate case costs,
14 which are components of utility operating income that are typically subject to
15 normalization in the context of a base rate case filing. The overall impact of all
16 these proforma adjustments is to reduce Mr. Effron's claimed revenue excess from
17 \$3,116,000 to \$222,000 and results in a return on common equity of 11.12% for
18 FG&E electric operations. I note, although I disagree with it, that the remaining
19 revenue difference, or revenue excess amount of \$222,000, continues to be
20 calculated using Mr. Effron's proposed return on common equity of 10.58%.

21

1 Q. Please summarize the impact of your updated test year, including year-end
2 common equity adjustment, on Mr. Effron's claimed revenue excess.

3 A. Application of the updated year 2000 test year, including the year-end common
4 equity adjustment reduces the revenue excess amount claimed by Mr. Effron by
5 \$1,243,000, as shown in Column (2) of Exhibit MHC-1, page 1.
6

7 Q. Please describe the normalizing adjustments to test year revenues and expenses.

8 A. I have made two adjustments, as detailed on Exhibit MHC-2 and MHC-3, and
9 shown in Columns (3) and (4) of Exhibit MHC-1, page 1.
10

11 The first adjustment, detailed on MHC-2, is to operating revenues to eliminate test
12 year 2000 base revenue related to Princeton Paper. Princeton Paper is the
13 customer I referenced earlier who was a major contributor to FG&E's increased
14 electric operations earnings. As of April 2000, almost a year ago, Princeton Paper
15 had filed for bankruptcy and ceased using electricity as a Special Contract
16 customer of FG&E. An auction was held on April 4, 2000 to sell the Princeton
17 Paper facilities. At present, Princeton Paper no longer exists. Because this
18 unique and very large Special Contract customer no longer contributes to the
19 revenues of FG&E, it is appropriate to make an adjustment for this known and
20

1 measurable change.¹ This adjustment reduces operating revenues by \$460,000.

2
3 Q. Why are you so sure of the impact of this single customer on FG&E's earnings for
4 its electric operations?

5 A. Quite simply, Princeton Paper was a unique customer to FG&E. In terms of size,
6 this customer had a very large load. During the test year period as a Special
7 Contract customer, Princeton Paper had an average monthly electric billing
8 demand of 16,341 kVa, representing more than 15% of FG&E's total monthly
9 billed demand to all its customers, and comprising more than 7% of FG&E's net
10 base revenues during the period it was in operation in the test year.

11
12 Q. If Princeton Paper's assets were auctioned, who bought them and what is the
13 impact of that new customer?

14 A. At the auction to sell the Princeton Paper's facilities, The Newark Group, a paper
15 company, bid for everything excluding the power plant offered in the auction.
16 After the bid was accepted, the Newark Group had the auctioneer sell a major
17 portion of the machinery, equipment, and stock on hand. Electric service to
18 Princeton Paper under the FG&E G-3 Tariff was discontinued and electric service
19 to the Newark Group was commenced on June 23, 2000.

¹ Princeton Paper shut down operations in early July of 1999. The Special Contract expired of its own accord on April 30, 2000, the last day to which the term had previously been extended. FG&E subsequently received notice from Princeton Paper that it was rejecting the EBS Agreement. Accordingly, electric service, formerly provided under the Special Contract and the Energy Bank Service Tariff was transferred to the standard FG&E, G-3 tariff effective May 1, 2000.

1 For the period of July 2000 through February 2001, the Newark Group's average
2 monthly billed demand was 648 kVa, or less than 4% of the average monthly
3 billing demand of Princeton Paper during the test year. Clearly the Newark
4 Group has not replaced the loss of load and lost net base revenues resulting from
5 the bankruptcy and discontinuation of the Special Contract between FG&E and
6 Princeton Paper.

7
8 Q. You described one of the normalizing adjustments shown on Exhibit MHC-1,
9 page 1. What is the second one?

10 A. The second adjustment, detailed on Exhibit MHC-3, is to Other Operating and
11 Maintenance Expenses to reflect an amount that FG&E would be allowed in a rate
12 case for normalizing adjustments in what I consider to be usual areas of expenses.
13 These areas include payroll, medical insurance, dental insurance, life insurance,
14 disability insurance, pensions, property insurance, liability insurance, bad debts,
15 postage, and inflation.

16
17 Q. How have you made this calculation of other *pro forma* expense adjustments?

18 A. For the purposes of this presentation I calculated an overall increase using
19 currently available forecast GDPIPD data for the calendar year 2001 and 2002.
20 Using this data, I calculated a projected inflation rate of 3.78% to escalate costs
21 over a 23-month period from the mid-point of the 2000 test year to the mid-point

1 of an assumed "rate year" of December 1, 2001 through November 30, 2002. I
2 applied the projected 23-month inflation factor to a calculated amount of O&M
3 expense that would be the subject of the above normalizing adjustments.
4

5 Q. How did you calculate the O&M expense?

6 A. As shown on Exhibit MHC-3, I calculated this O&M expense amount by
7 subtracting from total O&M expense, the items that would not be the subject of a
8 normalizing adjustment. These items consist of purchased power, fixed leases,
9 rental water heater program, and advertising/media relations. I then applied the
10 projected 23-month inflation factor of 3.78% to the resulting residual O&M
11 expense. This *pro forma* adjustment increases O&M expense by \$413,900.
12

13 Q. Is this a valid and reasonable approach for this adjustment?

14 A. Absolutely. This calculation provides a reasonable and even conservative amount
15 of expense increases that could be anticipated from rate case normalizing
16 adjustments.
17

18 Q. Why do you describe this form of normalizing adjustment "conservative?"

19 A. I previously indicated the several areas of O&M expense that would be subject to
20 normalizing adjustment in a rate case. I reviewed several of these areas for
21 known or anticipated increases when comparing the 2001 budget to the 2000 test
22 year expenses, and I found that many are slated to increase by much more than the

1 projected inflation rate. For example, the known payroll rate increases for 2001
2 are 3.5% and 4.9% for the union and non-union employee groups, respectively.
3 Medical and Dental insurance expenses are anticipated to increase by
4 approximately 18%, or \$89,000.

5
6 Q. Mr. Collin, Exhibit MHC-2 and Exhibit MHC-3 detail two normalizing
7 adjustments to Operating Revenues and Other O&M expenses that are
8 summarized against Mr. Effron's claimed revenue excess in Exhibit MHC-1, page
9 1. Are you aware of other components of utility operating income typically
10 subject to normalizing adjustment?

11 A. Yes. I am making specific adjustment in my calculation for two of those areas,
12 depreciation expense and amortization of rate case costs. These adjustments are
13 shown in Columns (5) and (6) of Exhibit MHC-1, and detailed in Exhibit MHC-4
14 and MHC-5, respectively. In addition, property taxes are typically normalized to
15 the level of most recent bills from municipalities. FG&E is anticipating an
16 increase in property taxes in 2001. I have conservatively not made an adjustment
17 for this anticipated increase at this time.

18
19 FG&E's depreciation rates on electric plant have been in place for some time.
20 They are the product of a depreciation study performed in the contest of FG&E's
21 last electric base rate case in 1984. A study was later performed in 1998 in
22 connection with FG&E's gas rate case, DTE 98-51. That study included a review

1 of depreciation rates on electric plant. The study's recommended depreciation
2 rates included provision for recovery of indicated reserve deficiencies over a
3 subsequent fifteen year amortization period. In DTE 98-51, the Department
4 adjusted the amortization period of a similar provision related to gas plant
5 depreciation reserves from fifteen years to twenty-five years. Similar adjustment
6 of the amortization period within the recommended rates for electric distribution
7 plant results in a composite depreciation rate for distribution plant of
8 approximately 4%. If one were to apply this rate to electric distribution plant
9 balances at the end of calendar year 2000, the annualized depreciation expense
10 that resulted would be a normalizing adjustment in a rate case. That calculation,
11 shown in Exhibit MHC-4, produces an annualized depreciation expense increase
12 of approximately \$627,000 over the expense of 2000.

13
14 Q. What impact does this have on Mr. Effron's claimed revenue excess?

15 A. The result is significant. As shown in Column (5) of Exhibit MHC-1, page 1, this
16 adjustment further reduces Mr. Effron's excess revenue amount by \$627,000.
17

18 Q. Please describe the adjustment for amortization of rate case expenses.

19 A. In preparation of a rate case FG&E would incur direct costs for presentation of the
20 case that would be amortized and included in resulting new rates to customers in
21 accordance with Department precedence. An amount of \$900,000 for such costs
22 would result in an annual expense of \$150,000 over a six-year amortization

1 period. This adjustment is detailed on Exhibit MHC-5. As shown in Column (6)
2 of Exhibit MHC-1, page 1, this further reduces Mr. Effron's claimed revenue
3 excess by \$150,000.

4
5 Q. What is the overall impact of your modifications and adjustments to the revenue
6 excess calculation performed by Mr. Effron.

7
8 A. As shown in Column (7) of MHC-1, page 1, the overall impact is to reduce Mr.
9 Effron's claimed revenue excess from \$3,116,000 to \$222,000 and results in a
10 return on common equity of 11.12% for FG&E electric operations. I note,
11 although I disagree with it, that the remaining revenue difference, or revenue
12 excess amount of \$222,000, continues to be calculated using Mr. Effron's
13 proposed return on common equity of 10.58%.

14
15 Q. With regard to the return on common equity used by Mr. Effron in his calculation
16 of claimed revenue excess, please explain the fundamental process undertaken to
17 develop an estimate of the return on common equity capital.

18 A. As I stated earlier, many tests and techniques can be used to develop an estimate
19 (a point estimate) of the return on equity, which estimates are typically analyzed
20 to develop a range of reasonable returns. The DCF analysis and the risk-premium
21 methodology are a couple of the traditional analytical frameworks used in utility
22 ratemaking. Good judgment and reasonable assumptions play an important role

1 in developing a just and reasonable estimate of a regulated company's allowed
2 return on equity.

3
4 Q. Does professional judgment play a role in developing the estimate of the return on
5 equity?

6 A. Yes. Professional judgement and specific assumptions may differ widely among
7 expert analysts. As a result, as the Department is keenly aware, two expert
8 analysts presented with the same data regarding a utility might suggest a different
9 estimate of the appropriate return on equity. Yet, both of these estimates may
10 well be based on sound financial modeling. The estimate of one analyst would
11 differ from another due to different assumptions or differences in methodology.
12 In the final analysis, the estimate of the return on common equity ends up being a
13 range -- a range within which the return on equity is deemed by the expert to be
14 just and reasonable.

15
16 Q. How is the allowed return on equity determined for a utility?

17
18 A. Virtually all state commissions determine the allowed return on equity capital
19 after a review of competent expert evidence on the appropriate return on equity.

20
21 Q. What is the relationship between the allowed return on common equity and the
22 actual return on common equity?

1 A. In practice, it would be only by coincidence that a utility would actually earn its
2 allowed return on common equity (i.e. the number designated by a rate order).
3 Over time, the actual return on common equity fluctuates to amounts lower and/or
4 higher than that allowed. However, rates are designed with the policy and theory
5 that over time the utility will or should earn, on average, the allowed return on
6 equity.

7
8 Q. If a utility earns less than the allowed return, can it come to the Department
9 seeking a change in one item to make up for the deficit?

10 A. No. A utility is not *entitled* to earn exactly the allowed return on common equity,
11 but rather is granted by the rate order *the opportunity* to earn the allowed return.
12 It must either figure out ways to drive efficiencies in its operations, or if it cannot,
13 it must be subject to a full rate investigation if it desires a rate increase. In the
14 end, between rate cases, the utility is at risk for the difference between its actual
15 return and its allowed return – there is no “true-up” or reconciling mechanism.

16
17 Q. Mr. Effron in this proceeding has advocated that FG&E's return on common
18 equity be set at 10.58%. In your view, is Mr. Effron's proposal of a 10.58% return
19 on common equity for FG&E reasonable?

20 A. No. Mr. Effron's use of the 10.58% return, even as an estimate, is flawed. First,
21 Mr. Effron uses the 10.58% return as a specific standard to support his claims that
22 even without expert testimony on FG&E's cost of common equity, its returns are

1 far in excess of any "reasonable range of cost of common equity to FG&E." To
2 the extent that Mr. Effron recognizes that experts in the field use "ranges" of
3 returns to describe what may be reasonable, I fail to understand how he settles on
4 10.58%. However, I do agree that, if the Department does not reject out Mr.
5 Effron's return on common equity testimony entirely, that FG&E's return should
6 be stated as a range.
7

8 Q. Do you have any other concerns about Mr. Effron's proposed 10.58% return?

9 A. Yes. The 10.58% return is what the Department allowed as a carrying charge on
10 the unrecovered balance of generation investment in FG&E's transition charge.
11 That determination, made over two years ago, is not in any sense a reasonable
12 proxy for a return on common equity that would be appropriate in the current
13 market. At most, it is a return component of an annuity to recover fixed transition
14 cost and in no way represents the risk of distribution operations or its relative cost
15 of capital. Further, Mr. Effron's proposal that a 10.58% return on common equity
16 is justifiable is also flawed because it fails to consider the increased risks that the
17 capital markets perceive for electric utilities following the utility financial crisis in
18 California, as well as the financial risk faced by FG&E as a result of the Attorney
19 General's claims in DTE 99-110.
20

21 Q. How is DTE 99-110, FG&E's Electric Cost Reconciliation Adjustment
22 proceeding for 1999, implicated by the Attorney General's complaint?

1 A. There are several outstanding and highly contested issues pending before the
2 Department in DTE 99-110 that could significantly impact the electric division's
3 return.

4
5 Q. What issues are presented in DTE 99-110?

6 A. The issues can be summarized as follows:

7 1. *What is the appropriate level of FAS109 in FG&E's transition cost?*

8 Amount in dispute: approximately \$262,000

9 2. *Should FG&E recover a return on its fixed investment during the first year of*
10 *retail access in its transition charge?*

11 Amount in dispute: approximately \$210,000
12

13 3. *Should FG&E be permitted to earn a return on the post 1995 capital additions*
14 *made to its generating units in its transition charge?*

15 Amount in dispute: approximately \$105,000
16

17 4. *May FG&E recover transaction and administrative costs associated with FG&E's*
18 *divestiture or may recover administrative and general in its transition charge?*

19 Amount in dispute: approximately \$2.1 million
20

21 5. *Can FG&E recover the power supply management and administrative costs*
22 *related to the provision of standard offer and default service?*

23 Amount in dispute: approximately \$1.8 million
24

25 6. *Does FG&E's Seabrook Amortization reflect the amortization intended under a*
26 *1985 Settlement provision?*

27 Amount in dispute: approximately \$1.8 million
28

29

1 Q. What is the total impact of the disputed amounts?

2 A. These amounts total approximately \$6.3 million. Therefore, because decisions in
3 DTE 99-110 could have a major impact on FG&E's earning and return, this action
4 and Mr. Effron's claimed revenue excess should not be viewed in isolation.
5

6 Q. Have you accounted for any of these impacts in your modifications to Mr.
7 Effron's claimed revenue excess (Exhibit MHC-1)?

8 A. No, I have not, because I cannot prejudge what action the Department may or may
9 not take with regard to them at this time.
10

11 VII. CONCLUSION
12

13 Q. What return on common equity do you believe is reasonable for the Department
14 to consider in evaluating the revenues of FG&E's electric operations?

15 A. Reports on major rate case decisions I have reviewed suggest an upward trend in
16 allowed returns for electric utilities during 1999 and 2000. I believe that in light
17 of the utility financial crisis in California and the regulatory risk being faced by
18 FG&E, that a reasonable range of returns under traditional cost of service
19 ratemaking would be 12 to 13 percent. The average allowed return in major
20 electric utility rate cases allowed in 2000 was 11.43%, up from the 10.77%
21 average allowed in 1999. Additionally, the average allowed return on common

1 equity in the 4th quarter of 2000 was 12.08%. Thus, in the absence of a full
2 analytical study, I believe the 12 to 13% range is reasonable.

3
4 Q. And using that 12 to 13% range of return on common equity, do you view
5 FG&E's probable earnings in the next year as excessive?

6 A. No, I do not. I believe FG&E's earnings will continue to be within a reasonable
7 range.

8
9 Q. Finally, Mr. Collin, is the methodology you present here (in effect your critique of
10 Mr. Effron) intended to advocate a level of rates for the Department to set for
11 FG&E in this proceeding?

12 A. Absolutely not. The purpose of this testimony, as I said at the outset, was to
13 describe in detail for the Department why Mr. Effron's proffered "back-of-the-
14 envelope calculation" of a claimed revenue excess was a completely insufficient
15 basis upon which to justify any change in FG&E's rates. I believe this testimony
16 has made the demonstration that no change is warranted, and moreover, that
17 FG&E's current rates are within a zone of reasonableness based on just a few
18 updates to Mr. Effron's methodology. As I perceive it, that is FG&E's burden
19 under the Department's procedural schedule. That said, at all times I recognize
20 the Department's precedent and policy that generally refuses to alter rates without
21 a full and complete opportunity to examine and investigate every aspect of a
22 utility's rates.

1

2 Q. Does this conclude your testimony?

3 A. Yes, for the current time. However, I must reserve the right to supplement this
4 testimony with any further information that is discovered that is relevant to this
5 proceeding.

6

7

8

9